Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
MCI Telecommunications Corporation Emergency Petition for Prescription of Access Charges	)	CC Docket No. 97-250
	)	
Consumer Federation of America Petition for Rulemaking	)	RM-9210

COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL

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Summary

The hundreds of pages of comments continue to make clear that competition exists for access services. The debate is only over how much. This is the same debate that was joined in the Spring of 1997, only now there is no dispute that the level of competition has increased.

In the debate over the extent of competition, many of the competitors of the SBC Companies use their dual identity as customers of the ILECs to attempt to cloud the debate. These commentors claim that they are really not active competitors, or that their competitive activities are minimal, in order to attempt to deny the ILECs any meaningful pricing flexibility, and to hinder their ability to compete.

The Commission should make a bold statement to competitors immediately in this proceeding that it will no longer protect them from full and fair competition. An order should be released as soon as possible as a sign to the marketplace that competition is about to heat up even faster than before. Competition would increase quickly upon the adoption of the USTA pricing flexibility plan. At a minimum, RFP and contract pricing would allow the ILECs to meet their competitors in these markets where competitive access providers are "cherry-picking" the most profitable customers, in many cases just because the ILECs have not been allowed even to bid against them in an RFP process.

The existence of competition also dictates that the X-factor should be reduced. None of the parties suggesting that an increase is warranted provide substantial evidence for a change in that direction. There is no more reason now to change the measurement of productivity to be on an "interstate-only" basis than there was in the 1997 Price Cap Order where such a proposal was correctly rejected.

Lastly, there is no reason in this record to take the drastic step of prescribing any access rates. The Commission should recognize that it would be terribly premature to exert even more stringent Federal government price control in the access marketplace, given the unfinished tasks of universal service reform, and the changes in access rate levels that will likely occur from that proceeding. Further, such price controls would have to be accompanied by an admission that FCC price cap regulation has failed, contrary to the Commission's own previous findings. Such an astounding acknowledgement would need to be followed by an admission that rate of return regulation would have provided better consumer welfare gains over the past seven years. This statement could only be adopted if all parties deny the clear evidence of the huge access rate reductions that have taken place thus far under price cap regulation.

For the reasons stated herein, SBC respectfully requests that the Commission promptly adopt the pricing flexibility proposal proposed by USTA, reduce the x-factor to reflect the most recent data, and deny the CFA and MCI Petitions.

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REPLY COMMENTS OF
SOUTHWESTERN BELL TELEPHONE COMPANY,
PACIFIC BELL, AND NEVADA BELL

Pursuant to the Public Notice released October 5, 1998[1] by the Federal Communications Commission (Commission), SBC Communications Inc., on behalf of Southwestern Bell Telephone Company (SWBT), Pacific Bell, and Nevada Bell (collectively, the SBC Companies) respectfully submit these reply comments to the comments[2] filed on the issues listed in the Public Notice. For the reasons stated herein, SBC respectfully requests that the Commission promptly adopt the pricing flexibility proposal proposed by USTA, reduce the x-factor to reflect the most recent data, and deny the CFA and MCI Petitions.

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[1] Public Notice, Commission Asks Parties To Update And Refresh Record For Access Charge Reform And Seeks Comment On Proposals For Access Charge Reform Pricing Flexibility, CC Docket Nos. 96-262, 94-1, and 97-250; RM-9210, (FCC 98-256) (Released October 5, 1998).

[2] A list of commentors is attached as Appendix A.

I. COMPETITION EXISTS.

In the hundreds of pages of comments filed in this proceeding two weeks ago, one finding is clear: competition exists for access services. The debate is now only over how much. Even if one could claim that the record was unclear on this point in the Spring of 1997, now there is no dispute that competition has increased to at least meaningful levels overall (and in some markets, extreme levels.)

Many of the commentors, who are also competitors of the SBC Companies, do not want to see the ILECs obtain any meaningful pricing flexibility, and want to hinder their ability to compete. These competitive local-long distance carriers want readers to believe that competition in the interstate access market is all about the state of local competition. SBC agrees that the state of local competition is undeniably important from a public policy perspective because an end user's decision to select a CLEC for its local service provider will also make the CLEC its switched access provider and, in most cases, its long distance provider for intraLATA and interLATA calls. However, focusing on the competitiveness of the local market is nothing more than the CLECs' latest self-serving attempt to financially harm ILECs.

This focus on local competition represents a significant flaw in the CLECs' comments since many of these competitors originally entered the interstate access market by constructing alternative transport networks. The Commission's collocation proceedings enabled further development of transport competition in the interstate access market. Competition in the access transport market was able to develop independently of local competition because IXC transport purchasing decisions did not rely upon whether the IXC also provided local service to end users. For these reasons many of SBC's major metropolitan areas are experiencing significant levels of transport competition, yet the Commission's rules continue to deny access customers the benefits of efficient competition by restricting the pricing flexibility that is available to ILECs. The Commission's rules must distinguish between the transport component and the switched access component of the interstate access market.

A. MANY OF THE COMMENTORS ATTEMPT TO MINIMIZE THE ACTIVE COMPETITION THAT ALREADY EXISTS.

Ad Hoc claims that SBC identifies a total of 1,017,883 "CLEC lines" across the seven-state SBC operating territory, but wrongly includes within this count 649,962 "CLEC lines" that were identified as "resold" SBC services.[3]

Ad Hoc's implication that resellers do not provide true competition is wrong. Just like the dozens of resellers of AT&T, MCI and Sprint long distance services, resellers of ILEC services are providing true competitive local service to end-users. For example, Birch Telecom provides resold services 'exclusively' and has installed a billboard in St. Louis stating "100% of our customers have fired Southwestern Bell", (see Appendix B). A true 'sign' that CLEC resold services replaces ILEC local service**.**

Once local service is provided to the end-user by the 'Competitive Local Exchange Company,' whether reselling or using its own facilities, that CLEC now brands that service as its own. The CLEC can offer a single bill, with both local and long distance provided by the CLEC, branded with its own name. The CLEC then has control over the customer for all future services or facility plans. If and when the CLECs builds their own facilities, they have the ability to migrate targeted customers to their new facilities, all of which is transparent to the end-user .

Reselling the ILECs local service is just one of several ways to enter the competitive local service market. Some CLECs may see resale as an interim method for providing service until they

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[3] Ad Hoc Pg.4

can more fully develop their network infrastructure. However, many CLECs have found resale an effective method for long term customer growth.

CPI cites the Merrill Lynch estimates of the gross local market share gains (in revenues) of CLECs to be about 5.4% of the entire local market by year end 1998 and only about 7.7% by the end of 1999. In terms of access lines, CPI notes Merrill Lynch's estimates that CLECs (including the IXCs) will serve about 2.9% of the nation's access lines by year-end 1998. CPI argues that by the end of 1998, competitors to the ILECs will serve only about 1.4 million (0.8%) of the nation's estimated 177 million access lines through UNE-based entry.[4]

While Merrill Lynch estimates that by the end of 1998, competitors to the ILECs will serve only about 1.4 million (0.8%) of the nations estimated 177 million access lines through UNE-based entry, UNE-based entry is only a partial measure of CLECs facility-based presence. The number of UNE-based services does <u>not</u> take into account the number of customers that are served <u>entirely</u> over competitors own facilities. A better measure of a competitors facility-based presence is their number of E911 listings. These CLEC E911 listings include all of the CLEC's customers regardless of whether local service is provided through resale, UNEs or CLEC constructed facilities.

In SBC Company territory, UNE-based listings amount to only 12.5% of the count of competitor's facility-based E911 listings (60,294 UNEs divided by 480,544 Facilities-based E911 listings). Applying this assumption to Merrill Lynch's estimates (1.4M is only 12.5% of the total number of CLEC served lines), a more accurate number of CLEC-served lines is 11.2M or 6.3% of the nations estimated 177M access lines (according to Merrill Lynch) by the end of 1998.

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[4]CPI p. 7-8.

Excel claims that competitive pressures cannot be relied upon to protect consumers and the public interest, citing figures released by the Commission.[5] The information Excel provides showing that CLECs served fewer than 160,000 access lines through UNE loops in the territories of nine large ILECs in 1997, however, is dated information and should be updated, if possible, to reflect a more current status. Excel also stated that "Furthermore, information gathered by the Commission shows that as of December 31, 1997, no competitor was utilizing unbundled loops in 16 states and competitors were using fewer than 100 unbundled loops in 12 states."

Nevertheless, the same report referenced by Excel (*Trends in Telephone Service*, FCC Common Carrier Bureau) shows 22 states with 100 or more unbundled loops (16 states with >100 < 10,000 loops; 6 states with > 10,000 loops). SBC provided over 19,000 loops to competitors as of December 1997. Although SBC's numbers do not reflect those of other ILECs, they do show a much more significant count than Excel references. To date, SBC has provided in excess of 59,000 loops to competitors.

RCN claims that less than 0.02% of buildings are connected to CLEC networks.[6] RCN wrongly uses this figure to argue the lack of competition.

CLEC facilities do not have to connect to every single building like the ILEC's. CLECs connect to the most lucrative buildings, in effect, cream-skimming. CLECs build-out when and to where it is economically feasible, not to where they are required to for regulatory reasons. In Dallas, TCG (now owned by AT&T) built facilities to the main downtown business district first, then along the IH 35E Stemmons corridor, then to the high-tech business district in Richardson, TX and then to the far north Plano, TX business center, Legacy Park, where several telecom-

[5] Excel p. 7.

[6] RCN p. 2

intensive commercial accounts have their headquarters. This is one example to show that facilities-based CLECs build only where and when it is economically advantageous to do so.

Other relevant evidence of competition (a listing of SBC Company competitors, together with an estimate of their existing facilities, is included in Appendix B attached hereto. A report on the SBC Company successes in opening local markets is attached hereto as Appendix C.

B. MCI UNREASONABLY MINIMIZES ITSELF AS A COMPETITOR.

MCI asserts that it does have the opportunity to avoid the ILEC access networks completely by building its own local facilities, but complains that the costs involved in building facilities are staggering.[7]

MCI admits, however, that it has the opportunity to avoid the ILEC access networks completely by building their own local facilities and also admits that they are doing so as quickly as possible. A few facts from MCI's own web page clarifies this[8]:

> MCI claims it is the leading competitive local exchange carrier (CLEC) in the U.S.
>
> MCI claims to serve millions of U.S. business and residential customers over a 45,000-mile, all-fiber high capacity nationwide network, enough fiber to stretch from San Francisco to Washington, D.C. 16 times.
>
> MCI claims its local service portfolio comprises 9,000 route miles of an advanced fiber-optic network, serving more than 100 cities nationwide.
>
> MCI claims its local networks are connected to more than 30,000 buildings, more than any other competitive local exchange carrier, including the Sears Tower in Chicago and the World Trade Center in New York.
>
> MCI claims it provides advanced data and Internet services. The company's Internet business is allegedly growing at a rate of more than 70 percent and generates more than $2 billion in revenue on an annualized basis. In addition, MCI claims to be the leading ATM

[7]MCI p. 21

[8]http://www.wcom.com/about_worldcom/corporate_overview/US_fact_sheet/

> service provider in the U.S. and to be among the top three providers of frame relay services in the industry.
>
> MCI claims its wholesale services unit provides service to more than 750 carriers and resellers worldwide.

Further, MCI claims it will require an investment of $21 billion to extend its local network facilities to 18% of the businesses in the U.S. However, with no obligation to deploy facilities to every business and residence, regardless of how remotely located, demanding access to long distance service, MCI can target its investment to effectively compete for the most profitable exchange access market segments. Clearly, deploying network facilities the length of Wall Street will have a far different competitive effect than investing the same amount of capital to ensure access to long distance networks for ranches in rural southwestern areas (probably among the 82% of businesses MCI's investment strategy does not consider). Regardless of the amount of investment capital committed to network facility deployment, MCI's ability to selectively target its construction programs to maximize profits should not be construed as a competitive disadvantage.

Thus, MCI should not be heard to complain of the costs of building facilities.

C. THE EIGHTH CIRCUIT'S DECISION ON THE BUNDLING OF UNEs IS IRRELEVANT TO THE ISSUES HERE.

Many parties claim that the Eighth Circuit's decision to vacate 47 C.F.R. Section 51.315(b) (the rule that required LECs to provide combinations of network elements) has rendered network elements unusable as a practical matter.[9] Nevertheless, despite the Eighth Circuit's ruling, several states (most notably Texas) still require the SBC Companies to recombine UNEs at minimal or no charge to CLECs. Since many commentors are still not satisfied with the

[9] AT&T p. 4, Ad Hoc p.6, CTSI pp. 2-3, Comptel p. 10, KMC pp. 2-3, RCN p. 3.

degree of competitive entry in Texas, the “glue charge” issue is not as critical as AT&T and others portray.

In Texas and Missouri, SWBT has been ordered to perform combinations for arbitrating CLECs, (which also includes any CLECs that MFN'ed into those agreements) for the term of the agreements. SWBT also offers UNE combinations in Oklahoma, Arkansas and Kansas under specific terms and/or agreements. In California, Pacific has agreed to combine UNE’s for Sprint, AT&T and MCI, pursuant to the agreements that preceded the Eighth Circuit's decision, and for any other CLEC who MFNs into an agreement that contains combining language for the remaining term of the underlying agreement. Nevada also has agreements that require UNE combinations.

MCI's characterization of requiring ILECs to combine UNEs as critical to the development of widespread local exchange and exchange access competition is also overstated. MCI is probably representative of all IXCs in its devotion of "considerable resources to seeking access alternatives.”[10] Requiring ILECs to combine UNEs would likely do little to foster access competition. Instead, each IXC would simply substitute a combination of UNEs for ILEC access service. In effect, regulation would require ILECs to sell the same service at two different prices. Clearly, IXCs striving to minimize access expenses would all choose the lowest price alternative.

Furthermore, there would be no incentive for an IXC to purchase access services from an alternative supplier when each IXC could order combined UNEs for itself without "paying a middleman." Regarding local exchange service competition, there is little (if any) conceptual difference between offering potential competitors combined UNEs or wholesale discounts for ILEC local services. Again, the same service would be offered at two different prices. Providing such tariff arbitrage opportunities for potential ILEC competitors indicates a relatively inefficient regulatory process since the lower price alternative will dominate its counterpart. Establishing two nearly identical alternatives (i.e., combined UNEs and wholesale discounts for ILEC tariffed services) with different prices might be construed as a waste of regulatory resources.

An example of a competitor actively using UNE combinations is Sage Telecom, Inc. As an article from the Dallas Morning News explains, Sage is a CLEC that is prospering by combining UNEs.[11]

Thus, the argument that the Eighth Circuit's decision impedes competition is a red herring. The SBC Companies have made combinations available, some CLECs are actively (and apparently successfully) using them, but commentors fail to properly acknowledge their effect on competition.

D. CURRENT PRICING TO THE CAP IS NOT AN INDICATION OF THE LEVEL OF COMPETITION.

AT&T claims that all of the price cap LECs continue to price at the maximum allowed by the price cap indices in virtually every basket, showing that there is no significant competitive pressure on the ILECs' access charges.[12] AT&T claims on p. 6 that "access charges have been reduced only when the Commission has taken action, not by any market forces."[13]

The SBC Companies have always made a concerted effort (as demonstrated in Supplier Performance Reports) to approach their customers' (the IXCs) desired price points for access, while balancing other stakeholder requirements (state regulators) consumer groups, capital markets, etc. To the extent that the SBC Companies have priced to the cap, much of the

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[10]MCI, p. 18.

[11] Dallas Morning News, October 18, 1998, pp. 1-3, Section H.

[12]AT&T, p. 5.

motivation resulted from the fact that access pricing is on a broad averaged tariff basis. The only means the SBC Companies had to meet specific customer price requests was to adjust the entire tariff. Obviously, this would have led to excessive revenue concessions in markets or from customers whose demand elasticity was not nearly as sensitive as requesting parties. While SWBT also attempted to implement numerous customer-specific optional payment plans, these plans were rejected. [14]

AT&T, on the other hand, received Tariff 12 and Tariff 15 flexibility at the start of its price cap regulation so that it could offer customer-specific pricing proposals and volume discount plans to respond to particular demand conditions. Extensive pricing flexibility was granted to AT&T years before it was judged to be non-dominant. ILECs, on the other hand, can only respond to particular customer requests or demand conditions in particular markets with permanent, across-the-board tariff price decreases (i.e., pricing below the cap). This is hardly a savvy marketing response to particular customer requests. Often, the foregone revenues that would result from permanent broad tariff price decreases do not justify accommodating a particular customer request or preserving demand in a specific geographic market. This is certainly true now with the current 6.5% productivity offset.

The economically efficient solution to this conundrum is to allow ILECs the flexibility that Competitive Access Providers (CAPs) have, or that AT&T had upon imposition of price caps. Geographic price deaveraging, customer-specific pricing, and volume-term arrangements are required to respond to specific demand conditions and to meet internal ILEC financial requirements necessary to justify targeted price reductions.

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[13] AT&T, p. 6.

[14] <u>See</u> Section II. A., <u>infra</u>.

E. CURRENT OSS INTERFACES ARE MORE THAN SUFFICIENT TO ALLOW COMPETITION TO FLOURISH.

AT&T claims that ILECs will not soon provide a workable, nondiscriminatory OSS interface that would be capable of processing the volume of orders necessary for a level of competition sufficient to put pressure on access charges.[15]

On the contrary, as of September 15, 1998, SWBT has 242 CLEC interconnection agreements in the five state region with OSS functionality defined and priced. Of that total, 210 CLECs are actively sending orders that utilize SWBT OSSs. Those CLECs that wish to submit orders electronically attend formal classroom training which SWBT developed for CLECs. To date, 46 CLECs and over 558 of their employees have attended these sessions intended to train the CLECs' staffs. CLEC students have reported a 99% overall satisfied rating with SWBT's classes. To date, 5,659 user identifications have been issued to CLECs for access to the SWB's OSS.

SWBT designed its electronic interfaces and OSS functions to be scaleable in order to quickly and effectively add capacity as volumes warrant. In preparation for CLEC usage of SWBT's electronic interfaces, SWBT made substantial investments increasing its OSS capacities. Just in SWBT's Information Services organization alone, SWBT has spent over $32 million since the passage of the Act.

SWBT has conducted tests to ensure these interfaces meet the expected CLEC volumes. September 1998 CLEC forecasts indicate that SWBT's ordering interfaces <u>today</u> can easily accommodate CLECs volumes through the year 2000. SWBT also monitors capacity needs, ready to add hardware to the existing infrastructure to accommodate growth.

[15] AT&T, p. 7.

SWBT has also established a number of support organizations specifically designed to serve the CLECs. These support organizations include the Local Service Center ("LSC"), Local Operations Center ("LOC"), Call Center, and Account Teams. The LSC serves as the single point of contact for CLECs for pre-ordering, ordering/provisioning, and billing and collection. The LOC serves as the single point of contact for CLECs for maintenance and repair twenty-four (24) hours a day, seven (7) days a week. The Call Center provides CLECs assistance and problem resolution for systems and applications made available to CLECs.[16]

F. THE PROPOSED SBC/AMERITECH MERGER WILL PROMOTE COMPETITION.

AT&T claims the large LECs' proposed mergers with each other – such as the proposed mergers of SBC with Ameritech and Bell Atlantic with GTE –threaten the public interest unless and until their access charges are reduced to cost.[17] AT&T claims that such mergers would deprive consumers of potential competitors.[18]

AT&T's claims should be disregarded here. As fully explained in the Applications for Consent to the Transfer and Control of Various Authorizations from Ameritech Corporation to SBC Communications Inc. (CC Docket No. 98-141) filed July 24, 1998, the merger is in the public interest and would promote, not deter competition. SBC and Ameritech are scheduled to file a reply on November 16, 1998 to the oppositions to their applications. The claims of AT&T are to be fully addressed there. The original application, as well as the forthcoming reply, are incorporated by reference here.

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[16] The LSC and LOC organizations currently consist of 673 management and non-management employees, who, through September 1998, have processed over 2 million orders since their inception in 1996. The cost of these functions exceeds $30 million annually.

[17] AT&T, p. 12.

[18] AT&T, p. 14.

G. THE COMMISSION MUST NOT BE TEMPTED BY MCI AND TIME WARNER TO ILLEGALLY ADD TO 271 REQUIREMENTS IN THIS PROCEEDING.

MCI argues that the fact that none of the RBOCs has even come close to obtaining 271 approval to enter the long distance market illustrates the ILECs' continued failure to comply with their basic duties under section 251 of the 1996 Act.[19] MCI also claims that most ILECs delay the ordering process for rolling over circuits to competitors for as long as possible due to their reliance on a basic circuit management system called Trunks Integrated Record Keeping System (TIRKS). MCI further alleges that the collocation process is extremely costly.[20] Time Warner argues that ILEC resistance to providing adequate collocation arrangements is slowing the development of competition.

The Commission must not be tempted to act on these charges. The subjects of these claims are part of the 251 and 271 processes. The commentors have a forum for these arguments in the negotiation and arbitration of interconnection agreements before state commissions, and the Commission here must be careful not to take any action that would add to the 251 and 271 statutory duties.[21]

Instead, the Commission merely needs to examine the competition that clearly exists. The regulatory relief that the ILECs are owed can then be tailored accordingly.

H. MARKET SHARE CANNOT BE BLINDLY USED IN ANALYZING ACCESS MARKET POWER.

ALTS claims that it while it would be premature to take prescriptive action, there is not enough competition to ensure that pricing flexibility by the incumbents would not stifle the

[19] MCI, p. 17.
[20] MCI, p. 21.
[21] 47 U.S.C. Section 271(d)(4).

competition that does exist and is continuing to emerge since new entrants have less ten percent of the total interstate access market. According to ALTS, such a "small" percentage of the market is not enough to allow any flexibilities.[22] ALTS wrongly claims that pricing flexibility was not seen as appropriate for AT&T until it had lost approximately 40 percent of the market and there were a number of firms with 5-10 percent of the market.[23] MCI goes further, and argues that competitors should have to achieve at least a 50 percent market share in revenue terms or 50 percent of the channel terminations between end offices and customer premises. According to MCI, if the ILEC has any affiliates operating in the same area, their market share should be counted as part of the ILEC's market share.[24]

MCI even further claims that the Commission should recognize that the transport market share measures typically used by the ILECs are extremely misleading as the ILECs typically report competitors' market share of "circuits" measured on a "DS1 equivalent" basis. According to MCI, this measure overstates CLECs' competitive inroads because it weights the type of facility for which ILECs have faced the most competition – entrance facilities -- more heavily than if a revenue measure were used. MCI asserts that a "DS1 equivalent" circuit-based market share measure could obscure an ILEC's dominance of the more significant (in terms of revenues) multiplexing, interoffice transport, and channel terminations between the end office and the customer premises.[25]

As SBC explained in its comments, market share measures of market power may overestimate the market power of the incumbent provider. Further, MCI's argument regarding

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[22] ALTS, p. 6-7.
[23] ALTS,p. 8.
[24] MCI, p. 55.
[25] MCI, p. 55.

the manner in which to measure market share is entirely backwards. MCI's logic would suggest that a competitor would LOSE market share by cutting price, as shown by the following numerical example:

	MCI	ILEC
DS1 EQUIVALENTS	1,200	1,000
PRICE	$80	$100
REVENUE	$96,000	$100,000
DS1 EQUIVALENT SHARE	54.55%	45.45%
REVENUE SHARE	48.98%	51.02%

If an ILEC has 1000 circuits at $100 each, it has revenue of $100,000. If MCI has 1200 circuits at $80 each, then it has only $96,000 revenue. A circuit measure would demonstrate that MCI in this example would have 1200/2200 = 54.55% share, while a revenue measure would show that MCI serves less than half the market (96000/196000 = 48.98%). This example shows that MCI's measure has the perverse result of cutting their market share every time they aggressively cut prices.

The DS1 equivalence used by SBC is appropriately measured. The circuit equivalent basis is indicative of the competitor's ability to compete with the ILEC. The revenue basis advocated by MCI is indicative only of the pricing policy and can be grossly misleading as shown in the examples above.

Researchers can analyze market share either by equivalent circuits or by revenues. A greater level of accuracy, however, is achieved by conducting market share analysis by equivalent circuits. The key issue is whether there should be a significant difference in market share depending on how it was measured: in terms of equivalent circuits or in terms of revenues.

As described in the example above, there can be a difference in market share between revenue measurement and equivalent circuits measurement. How much of a difference really depends on the specific conditions of the marketplace. It is heavily dependent on the pricing strategy of the competitors, which are affected by many factors including the network utilization level, the geographic location, and the number and overall strategy of the existing competitors. There would thus be an increased volatility in market share if measured in terms of revenues than in terms of equivalent circuits.

II. PRICING FLEXIBILITY IS REQUIRED NOW.

A. AT A MINIMUM, RFP PRICING FOR PRICE CAP LECs IS LONG OVERDUE.

ALTS wrongly argues that RFP and contract rate authority should be placed at the end of any phase-in of pricing flexibility not at the beginning.[26] Ad Hoc, on the other hand, supports the availability of RFP pricing flexibility to allow ILECs to respond to RFPs with contract price offers in competitive situations.[27]

As noted above, SWBT requested the ability to respond to competitive bid situations on two separate occasions. In the first case, this minimal flexibility was denied by the Commission, but the U.S. Court of Appeals admonished the Commission for not specifying the level of competition that was necessary to achieve this level of flexibility, and remanded the matter.[28] SWBT filed a second transmittal to respond to a competitive bid situation and this too was denied, but the promise was made that in the near future, based on a more complete record, this flexibility would be examined:

> In the Access Charge Reform proceeding, we are considering various proposals concerning pricing flexibility for incumbent LECs. The various proposals concern, inter alia, the issues of competitive response tariffs, contract tariffs, volume and

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[26] ALTS, p. 9.
[27] Ad Hoc, p. 27.
[28] Southwestern Bell Telephone Company v. FCC, 100 F.3d 1004 (D.C. Cir. 1996).

term discounts, geographic deaveraging.[29]

Commissioner Furchtgott-Roth was more explicit:

> Nevertheless, I write separately because I believe that the majority's decision, in its public interest analysis, addresses issues that are more appropriately considered in the context of the pending Access Reform proceeding's broader inquiry into pricing flexibility for dominant local exchange carriers (LECs). The competitive necessity defense issue raised by SWBT's tariff transmittal is only part of the larger issues concerning pricing flexibility for dominant LECs. As such, the more developed record in the Access Reform proceeding provides the appropriate context in which to consider the issues relating to the circumstances under which dominant LECs should be accorded additional pricing flexibility. Consequently, I reserve judgment on those issues until the upcoming Access Reform order.[30]

Commissioner Powell agreed:

> I agree that at this time, based on this record, we cannot grant the broad relief the company seeks. I do so reluctantly in cases where consumers stand to benefit from lower prices, as is the case here. However, I am convinced that to grant the relief requested now would very possibly raise new barriers to entry and that the question of pricing flexibility is a component of a whole host of complex questions that are best addressed in our Access Reform Proceeding. Nonetheless, I write separately to emphasize how important it will be for the Commission to provide clear guidelines as to when and under what conditions, dominant local exchange carriers can offer customers lower prices in response to competitive pressures from new entrants as we transition from a regulatory regime to a market-oriented one.[31]

Based on the possibility that the long-promised order in Access Reform might not address pricing flexibility promptly (a prediction that has unfortunately been fulfilled), SWBT filed for reconsideration. SWBT's petition was rejected. Again, SWBT was told to await the order in this proceeding. Commissioner Furchtgott-Roth noted that the rejections "turn logic on its head":

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[29] Southwestern Bell Telephone Company Transmittal No. 2633 Tariff F.C.C. No. 73, CC Docket No. 97-158, Order Concluding Investigation And Denying Application For Review (FCC 97-394) (Released: November 14, 1997), para. 56 (RFP Order), aff'd on recon., Memorandum Opinion and Order on Reconsideration (FCC 98-38) (released March 13, 1998) (RFP Reconsideration Order).

[30] RFP Order at Concurring Statement of Commissioner Harold Furchtgott-Roth.

> I write separately, however, to continue to urge the Commission to consider the issue of pricing flexibility for dominant exchange carriers in the context of the Commission's pending Access Charge Reform proceeding. As I stated in the Commission's original denial, the issues raised by Southwestern Bell's tariff are only part of the larger issues relating to pricing flexibility of dominant LECs in general. I have serious reservations about the majority's initial conclusion that the public interest could be thwarted by allowing customer-specific tariffs. The accompanying economic theories relating to "limit pricing" and the incentives a LEC may have to lower prices to deter entry turn logic on its head; consumers benefit, and the public interest is served, when prices are lowered. Thus, I continue to await anxiously the opportunity to address more fully these issues and the circumstances under which dominant LECs should be accorded additional pricing flexibility.[32]

In this proceeding the Commission should wait no longer to redress the inaccurate economic theories listed by Commissioner Furchtgott-Roth.

B. GEOGRAPHIC DEAVERAGING IS NECESSARY FOR COMPETITION TO FULLY DEVELOP.

AT&T claims that geographic deaveraging would permit an ILEC to keep rates at supracompetitive levels in lower density areas where competition has not emerged, and to use those revenues to subsidize predatory pricing in high density zones where there is some competitive entry. An ILEC could allegedly thereby drive efficient rivals from the market, and discourage others from entering at all.[33]

As defined in the economics and antitrust law literatures, a successful predatory pricing scheme must follow a definite series of stages. (1) The predatory firm must price an inelastic service below incremental cost for a period long enough to drive alternate providers out of the market. (2) The predatory firm must finance this below-cost pricing by raising prices of its other

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[31] RFP Order at Separate Statement of Commissioner Michael K. Powell.

[32] RFP Reconsideration Order at Concurring Statement of Commissioner Harold Furchtgott-Roth.

[33] See Attachment A, Janusz Ordover and Robert Willig, "On Reforming the Regulation of Access Pricing," pp. 9-12, AT&T p. 9; MCI p. 62

services until competitors exit the market. (3) The predatory firm must maintain supracompetitive prices even after the competition exits the market in order to recoup the losses the predatory firm sustained during the below-cost pricing stage. Beyond taking years to complete, predatory pricing schemes in telecommunications are unlikely to succeed. Even if a firm drives competitors from a particular market, the failed competitors' network capacity remains. Acquisition of this abandoned capacity by entrants must be precluded if a predatory pricing scheme is to succeed. It is unlikely an ILEC will drive all competitors from a market expecting to either acquire or destroy the failed firms' existing network facilities while completely eluding detection. In the case of telecommunications, the predatory firm must accomplish its plan unnoticed by the watchful eye of scrupulous regulators and Justice officials.

In the light of antitrust law, AT&T's unsubstantiated claims of likely predatory pricing are preposterous. Successful completion of all stages of a predatory scheme assumes that the Commission, DOJ, and industry would be so complacent as to allow the predatory firm to sustain possible net financial losses for years until recoupment is complete. Without question, these requirements do not characterize the telecommunications industry in 1998.

SBC's Comments (p.15) cited a strong retort by Commissioner Powell to AT&T's "sky-is-falling" claims of likely results stemming from "premature" ILEC pricing flexibility:

> Rather than imagining all the dangers that might result if we let a company do what it has asked and then take equally speculative action to meet those speculative dangers, let's instead police conduct and make decisions based on real acts. If there are "teeth" in our enforcement efforts, companies will take heed or pay the price.[34]

[34] "Technology and Regulatory Thinking – Albert Einstein's Warning" address given by Michael Powell at Legg Mason Investor Workshop, Washington, DC, March 13, 1998.

As SBC has noted, assuming the ILEC to be guilty of predatory pricing without evidence (or any behavior proven) is manifestly unfair. Such claims provide no basis to delay pricing flexibility.

C. TERM DISCOUNTS ARE PROPER AND SHOULD NOT BE UNDONE AS PART OF ANY PRICING FLEXIBILITY PLAN.

KMC asserts that time limits must be placed on discounted offerings since ILECs will use these offerings to “lock-up” customers absent time limits on the terms of these contracts. Accordingly, KMC wants the Commission to limit the time period of any discounts or contract tariffs.[35] MCI argues that before granting an ILEC contract pricing authority, the Commission must take affirmative steps to ensure that transport customers can actually switch suppliers. First by requiring ILECs to waive nonrecurring charges associated with the rearrangement of transport facilities to a competitor and second, by permitting "fresh look" for term plans.[36]

These allegations that ILECs' use of long term contracts retards competition in access markets is overstated. Such contractual arrangements clearly are not undesirable *per se*. Rather, MCI's critical view of ILEC long term contracts for access services appears to be motivated by its own changed circumstances. Presumably MCI was not tricked into signing a series of grossly discriminatory contracts with ILECs. MCI probably voluntarily entered into such agreements "in order to receive the best rates available."[37] Now that MCI is the "CLEC with the greatest reach and most facilities,"[38] however, contracts which previously were attractive enough to warrant commitments now are bemoaned as containing "grossly excessive termination liabilities."[39]

[35] KMC, p. 7; MCI p. 20.
[36] MCI, pp. 50-51.
[37] Id., p. 20.
[38] Id., p. iii.
[39] Id., p. 20.

The use of term contracts in exchange access markets, regardless of MCI's claims, does not represent an anticompetitive practice. MCI itself likely has similar contracts with high volume retail long distance customers. The presence of such contractual ties between IXCs and high volume corporate accounts is likely viewed by IXCs as an example of the type of pricing flexibility necessary for survival in fiercely competitive market segments, not an anticompetitive practice. In exchange access markets, however, those same IXCs condemn ILEC term contracts as "roadblocks" to competition. Suggestions that ILEC term contracts be declared void to aid the development of competition in exchange access markets should be given as much weight in policy decisions as suggestions that IXCs' retail toll contracts be similarly declared void to encourage competition as ILECs gain entry to interLATA long distance markets.

D. THE CURRENT FLEXIBILITIES GIVEN TO THE ILECs DO NOT ALLOW FOR FULL COMPETITION TO DEVELOP.

MCI claims that the Commission should not grant additional pricing flexibility unless there has been a clear demonstration that existing pricing flexibility is inadequate to respond to actual competition. MCI argues that the ILECs have generally failed to utilize their existing pricing flexibility, citing the market for switched transport services, where the ILECs have allegedly made little or no use of price cap rules that permit geographic deaveraging of transport rates and term and volume discounts.[40]

MCI fails to see, however, that the current regulatory environment of price caps, productivity factors, and average rates are not conducive to true market based pricing by the SBC Companies or encourage such pricing from the competition. Pricing decisions by the SBC Companies are primarily shaped by requirements to have average rates. The SBC Companies'

[40] MCI, p. 36.

ability to respond to specific competition is therefore constrained. Price caps, coupled with annual "productivity" adjustments, force the SBC Companies to establish rates based on its total market rather than competitive challenges. SBC Company competitors, without similar total market burdens, have the benefit and unfair advantage of pricing services that either 1) have focus to selected strategic key markets and customers or 2) are set as a standard discount below the SBC Company's rates. Absent the current regulations, the market response by the SBC Company would result in further reduction of rates for key markets.[41]

The existence and viability of the SBC Company term discounts further demonstrate a competitive marketplace and provide an economic benefit to customers. Without a competitive threat, there would be no financial incentive to offer the discounted rates inherent in the term plans. Without a competitive threat, the SBC Companies would have 100% of their customer base committed to term plans for the longest term available. Neither of the aforementioned is true. If term discount plans can be asserted to be "anti-competitive" because of market responsiveness, then general rate reductions and introductions of new services would also be candidates for that description.

Zone pricing was an initial first small step attempting to address the pricing flexibility imbalance between SBC Companies and their competitors. The zone pricing rules have the following shortcomings:

--Rules permitting only 3 density zones are insufficient for today's complex market.

--The density zones are based on the SBC Company's facility quantities without consideration of alternative suppliers. Market growth lost to the competition does not

[41] Additionally, the Low End Adjustment should be eliminated with the adoption of overall Price Cap Reform (i.e., pricing flexibility and adoption of a more realistic productivity factor.) This will enable the Commission to forge ahead with reform of depreciation regulation and also removes a major vestige of rate-of-return regulation.

reflect itself in the zone designation. This hinders the SBC Company's ability to respond to its competitors.

--Within the same "zone", there are unique customer profiles and market needs that should have unique solutions.

--The "zones" are only based on quantity without consideration of other factors which attract competition such as growth rate, strategic importance, product mix, etc.

E. PRICE SQUEEZES ARE NO THREAT IN THE ACCESS MARKETPLACE.

AT&T admonishes against potential price squeezes by ILECs. AT&T claims that any margin in access prices above incremental cost will lead to ILECs engaging in price squeezes against potential long distance competitors.[42] This argument must be rejected.

AT&T's error in its price squeeze accusations lies in the ostensible "cost advantage" it claims an ILEC subsidiary would have in offering interLATA long distance due to its ability to obtain access at incremental cost from an ILEC. In-region interexchange services, however, must be offered through a separate subsidiary.[43] The ILEC interLATA affiliate would *not* be able to purchase access at incremental cost from its affiliated ILEC. The interLATA affiliate's effective cost of obtaining "in-region" access service is *not* the incremental cost its affiliated ILEC incurs in providing access. Rather, the interLATA affiliate's effective cost of access is the same rates, under the same terms and conditions, that its interLATA rivals have available to them from the ILEC. The ILEC would be required to charge the same access rates to its interLATA affiliate as it changes to other long distance customers. With no cost advantage attributable to access, the ILEC affiliate would have nothing to exploit through lowering interLATA prices. There simply would be no price to squeeze.

[42] AT&T, pp. 11-12.
[43] 47 U.S.C. Section 272(a)(2)(B)

Unless ILECs are operating simultaneously in the exchange access and interLATA long distance markets, their ability and incentives to engage in price squeezes are, by definition, nonexistent.[44] ILECs' entry to interLATA toll markets depends upon regulators' determination that ILECs have satisfied the statutory competitive criteria. Further, ILEC provision of interLATA long distance service will require creation of separate subsidiaries, which will purchase ILEC (or CLEC) access at the same rates available to IXCs. Attempting a price squeeze in such circumstances will simply reduce the prospects for success for the ILECs' own subsidiaries.

In addition, attempted price squeezes, with competitive access markets, will be doomed to fail. IXCs will simply switch access suppliers to secure lower prices. Indeed, the major IXCs will have their own subsidiaries' facilities to rely upon if they perceive ILEC prices as inappropriate. IXCs' commitments to enhance recently acquired local network facilities to compete with ILECs will, in large part, eliminate price squeezes as potentially serious concerns in regulatory proceedings.

AT&T claims "the persistence of above-cost access charges pose a substantial anticompetitive risk with respect to the long distance market, because they give the LECs the ability to execute price squeezes against their interexchange rivals."[45] The implication that ILEC access charges above cost are somehow anticompetitive is misleading. While the phrase "above cost" is not precisely defined by AT&T within the context of its price squeeze arguments, this notion is typically associated with the IXCs' phrase "forward looking, long run, incremental costs of an efficiently operating firm." ILEC access charges that contribute toward the recovery of

[44] Curiously, AT&T (which is one of two telecommunications suppliers with both the ability and incentives to effect an anticompetitive price squeeze) raises price squeeze concerns. AT&T, pp. 11-12.

[45] AT&T, p. 11.

shared costs (including corporate overhead) do not constitute an anticompetitive practice. Certainly, Teleport and MFS service prices prior to their acquisitions by AT&T and MCI WorldCom, respectively, were intended to recover corporate overhead expenses. To the extent Teleport prices to end users connecting to networks other than AT&T's did not fall to eliminate contribution to shared costs, AT&T is engaging in the type of price squeeze about which it is complaining. Further, unless Teleport's prices are set equal to the same "forward looking, long run, incremental costs of an efficiently operating firm" that AT&T presumably desires to impose on ILEC access charges, then perhaps AT&T's simultaneous participation in exchange access and interLATA toll markets (not the ILECs' potential future entry) "threatens the public interest."[46]

III. THE X-FACTOR SHOULD BE REDUCED.

A. PRODUCTIVITY IS CORRECTLY MEASURED ON A TOTAL COMPANY BASIS.

Another ridiculous tactic being proposed by the IXCs in order to increase the already overstated X-Factor is that the X-Factor should be based on interstate data only and not on total company productivity data.[47] As Professor Frank M. Gollop emphasizes in his report:

> It is an uncontested principle of microeconomic theory that production of multiple products with common and joint inputs is not separable into distinct parts. Economic theory is clear. The concepts of interstate or intrastate productivity growth just do not exist. In short, one <u>cannot</u> examine the cost (productivity) conditions of each output in isolation because the multiple outputs <u>are not</u> produced in isolation.[48]

AT&T claims Pacific and several major price cap LECs have effectively conceded that the LECs' relatively higher interstate output growth rate would require an upward adjustment in the LECs'

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[46] Id., p. 12.

[47] AT&T, p. 16.

[48] An Economic Assessment Of An "Interstate-Only" X-Factor Model, Frank M. Gallop, Nov. 4, 1998. See USTA Reply Comments being filed today, Attachment C.

total factor productivity ("TFP") rate determined on a total company basis. And that Dr. Christensen endorsed this same principle in testifying before the California public utilities commission. AT&T also indicated that Dr. Christensen emphasized that there is a direct relationship between the demand (output) growth of the LECs and their total factor productivity growth, and consequently a change in the demand (output) growth for a LEC results in a proportional change in that LEC's TFP growth rate.

Pacific has never effectively conceded that "the LEC's relatively higher interstate output growth rate would require an upward adjustment in the LEC's total factor productivity ("TFP") rate determined on a company basis."[49]

Pacific Bell has always advocated a total company approach in price caps. It has never advocated an intrastate productivity measure in California nor an interstate-only factor in the federal jurisdiction. The analysis by Christensen was not an analysis of interstate output, inputs and productivity. Establishing a link between output growth and TFP growth does not establish a link between interstate output growth and interstate productivity. To develop interstate TFP one must be able to develop meaningful measure of interstate inputs and this has <u>not</u> been done.

While AT&T apparently finds it worthwhile to suggest an alleged "interstate TFP" measure, it has <u>not</u> been consistent by suggesting that an intrastate TFP measure be used in California. AT&T supported Dr. Selwyn's TFP productivity factor recommendation in the 1995 review of the California price cap (AT&T Brief). Dr. Selwyn's TFP factor was based on Dr. Christensen's model that is based on **total** company results.

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[49] AT&T, p. 18.

Ad Hoc also claims that there exists a difference between LEC interstate and intrastate productivity levels. Ad Hoc alleges that LECs have argued that such differences exist, citing California proceedings.[50]

Ad Hoc mischaracterizes the testimony in California's 1995 review of its price cap. The CPUC's second triennial investigation asked several far reaching questions, one of which was "Should GDP-PI minus X (inflation minus productivity factor) in the price cap formula be modified or eliminated?" In answering this important question, many factors were necessarily considered. Indeed, the CPUC's summary statement reflects the extent and thoroughness of its investigation.

> In this decision, we find that the 5% productivity factor for Pacific Bell is inappropriate for the next three years primarily because the underlying assumptions and data on which the 5% rate was based are obsolete. D95-12-052, p. 1.

Pacific did not limit its testimony to intrastate-specific performance. For example, when analyzing the financial impact of the regulatory program, Pacific provided testimony on **total** company financial performance.[51]

Pacific Bell's testimony on competition was oriented to competition in California because it is an area where competition is intense and is particularly relevant for California regulators. In the important area of productivity performance, Dr. Christensen presented evidence on telecommunications industry productivity and Pacific Bell's likely performance. One of his conclusions was that "The Commission has found, and I concur, that a TFP growth differential based on industry-wide TFP is preferable to a company-specific TFP measure to be included in

[50] Ad Hoc, Pg. 15.

[51] Investigation on the Commission's own Motion into the Operations and Safeguards of the Incentive Based Regulatory Framework for Local Exchange Carriers, California PUC Docket No. 95-05-047, Evans Direct, Sept. 8, 1995, pp. 6-15.

the X factor when a price cap formula approach is used."[52] This TFP measure is based on **total industry, total company results**. "Total output includes all services provided by the telephone local exchange carriers: local service, long distance service, intrastate access service, interstate access service, and miscellaneous services. Total input includes all inputs used by the local exchange carriers: capital (plant and equipment), labor, and materials, rents, and services."[53] Pacific has clearly not claimed what Ad Hoc alleges.

The CPUC has recently completed its third triennial review of the price caps and has continued the suspension of the price index formula.

B. PRICE CAP LECs' EARNINGS LEVELS ARE IRRELEVANT TO THE SETTING OF THE X-FACTOR.

GSA and AT&T claim that high earnings by price cap carriers demonstrate that a significant increase in the X-Factor is now justified.[54] GSA asserts that the Commission established the productivity offset to meet an objective rate-of-return for LECs under price cap regulation.[55] GSA does note, however, that SWBT experienced a decrease in its rate-of-return from 1991 through 1997.[56]

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[52]Investigation on the Commission's own Motion into the Operations and Safeguards of the Incentive Based Regulatory Framework for Local Exchange Carriers, Telephone Industry Productivity Performance and Its Implications For the Pacific Bell Price Cap Formula, California PUC Docket No. 95-05-047, Christensen, Sept. 8, 1995, p. 19.

[53]Investigation on the Commission's own Motion into the Operations and Safeguards of the Incentive Based Regulatory Framework for Local Exchange Carriers, Telephone Industry Productivity Performance and Its Implications For the Pacific Bell Price Cap Formula, California PUC Docket No. 95-05-047, Sept. 8, 1995, Christensen, p. 7.

[54]GSA, p. 3; AT&T p. 24; <u>see also</u> CFA, p. 3.

[55]GSA, p. 3.

[56]GSA, p. 5-6.

These commentors ridiculously insist that the rates of return achieved by the Price Cap industry calls for substantial increases to the X-Factor. As correctly noted by AT&T in trying to explain their increases in rates of return in comments filed in the 1992 NOI:

> Rates of return cannot be compared directly to percentage price changes mandated by the price cap index or otherwise achieved through efficiency gains. Rate base is of course less than total revenues, and thus any given percentage increase in output (in relation to revenue) may yield a greater percentage of return increase. More importantly, efficiency is a function of changes in output with given inputs, which include economic capital costs rather than any changes in book capital, as used in the calculation of rates of return.[57]

AT&T also stated that:

> The existing productivity factor is an integral part of the price cap regime's attention to prices charged consumers rather than the carrier's rate of return. It establishes the long-term, historical baseline of performance that AT&T must meet and beat before AT&T may profit from its efficiencies or innovations. Once that baseline has been set, price cap regulation must supplant rate of return regulation to produce the intended benefits of the new regulatory regime.[58]

Additionally, in AT&T's quest to keep the Commission from raising its X-Factor:

> The adoption of price cap regulation purported to require AT&T to exceed historical efficiency gains by .5 percent annually (and cumulatively) before it could profit from its greater efficiencies and service innovations. Any increase in the productivity factor would thus represent a truly enormous departure from the initial purpose and scope of the price cap index. An increase in the productivity would be completely inconsistent with the equitable allocation of benefits between consumers and AT&T's shareholders that the Commission expected price cap regulation to produce.[59]

The Commission has, according to its order, already set the price cap LECs in the upper end of the range of reasonableness. Further, the most current updates to both the USTA TFPRP model, and the Commission's X-Factor model, strongly support that the 6.5% X-Factor must be lowered.

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[57]CC Docket No. 92-134, AT&T Comments, Sept. 4, 1992, fn. 86.
[58]CC Docket No. 92-134, AT&T Comments, Sept. 4, 1992, p52
[59]CC Docket No. 92-134, AT&T Comments, Sept. 4, 1992, p44-45

Any increase as AT&T stated, based on historical efficiency, would thus represent a truly enormous departure from the initial purpose and scope of the price cap index.

As USTA states in its Reply Comments being filed today, depreciation rules have been one major reason AT&T was correctly cautious in the past about the inability to decipher productivity from regulated accounting earnings. The major ILECs and AT&T both have recognized many billions of regulated asset writedowns on their SEC/GAAP financial statements. Also, the Commission staff's productivity model calculated BOC regulated depreciation rates at an average of 7.3%, while recent Value Line reports indicate that AT&T's and MCI's 1997 depreciation rates were 8.6% and 13.6%, respectively. If the ILEC's composite depreciation rate were only 1% higher, annual reported earnings would be reduced by approximately 1.4%.

Still other facts support a lower X-Factor. The X-factor model developed by the Commission is sensitive to changes in real and/or financial variables that affect the Commission's measurement of prices and quantities for RBOC inputs and outputs. The report prepared by Professor Gallop quantifies the effect of two such changes in the RBOCs' economic environment on the X-Factor as measured by the Commission.

The first change reflects the impact on the Commission's X-Factor due to the reduction in RBOC employment, which proceeded at an annual 4.9% rate over the 1991-95 period, and has slowed considerably in both 1996 and 1997. Since the TFP is defined as weighted average growth in outputs less the weighted average growth in inputs, the 1991-95 reductions in the RBOC's labor force had a positive effect on the measured rate of TFP growth reported for that period in the FCC model.

Even if all other economic conditions remain unchanged, TFP growth and therefore the calculated X-Factor in the near future might be expected to be lower than their corresponding values observed in the pre-1995 period. If the RBOCs' near term employment levels remain stable or decline at only half the rate observed in the 1991-95 period, then, other things equal, one should expect the X-Factor in the coming years to be no less than 0.4 to 1.0 percentage points below the level witnessed in the earlier 1991-1995 period.[60]

The second change reflects the impact on the Commission's X-Factor due to rate restructuring under Access Reform. Other things equal, these revenue shifts (the effect of the price changes by shifting interstate revenues from switched access minutes to access lines) would affect the weights applied to interstate outputs in the Commission staff's X-Factor model, thereby affecting the measures of TFP growth and the derivative X-Factor. The results show that the measured average annual growth rate in total interstate output over the 1986-97 period would have fallen by nearly 0.8 percentage points under access reform. Thus, since interstate revenues have roughly a 25% share in total company revenues, growth in total company output over the 1986-97 period would have been reduced by 0.2 percentage points.

The two simulations are independent and mutually exclusive. Thus, the cumulative effect of these two changes to the RBOCs economic environment, other things being equal, will lower the industry’s X-Factor in 1998 and later years from its calculated 1991-95 levels by amounts ranging between **0.6 and 1.2** percentage points.[6]

Increases in ILEC earnings are an indication that incentive regulation is working. Improved earnings serve as the reward to ILECs for besting productivity targets, and for bearing the financial risk of investing and operating in an increasingly competitive market. Improved earnings are not something for which to punish ILECs. As Dr. William Taylor states in Appendix

[60]Sensitivity Analysis of the FCC X-Factor to Changes in Economic Variables, Frank M. Gallop, Nov. 3, 1998 p. 6. See USTA Reply Comments being filed today, Attachment D.

B of USTA's Comments:

> Price cap regulation only makes sense if the regulated firm is financially exposed to the full range of market outcomes produced by its skill or stupidity. If increased earnings come to be interpreted as a failure of price cap regulation, then price cap regulation will become little more than rate of return regulation in disguise.[61]

MCI claims that based on the most current data, the ILECs' true cost of capital is now only 9.1%, and that represcription is warranted along with a downward adjustment in the low end adjustment mechanism.[62] These subjects are misplaced here. There is a separate docket to address these issues, CC Docket No. 98-166. SBC reserves its response to the proper time in those proceedings.

IV. GOVERNMENT PRESCRIPTION OF ACCESS RATES IS UNFOUNDED.

A. THE COMMISSION'S OTHER REFORMS MUST BE ALLOWED TO WORK BEFORE ANY INQUIRY AS TO THE REMAINING COSTS OF ACCESS SERVICES.

As CBT has stated, until the Commission implements pricing flexibility rules, it cannot begin to assess the effectiveness of its market-based approach to access reform. A further complication is the fact that the universal service plan is still unresolved. As a result, significant subsidies remain in the access rates. SBC agrees with CBT that with the delay in implementing the universal service reforms, the Commission should extend the February 8, 2001 date on which it will review LEC's costs so that any changes implemented as a result of the new universal service plan will have adequate time to take effect.[63]

Time Warner concurs, stating that the Commission's modified market-based approach to access charge reform continues to present the optimal course. Time Warner also notes that any

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[61]USTA, Appendix B, p.11.
[62]MCI, p. 34**.**
[63]CBT, at p. 8.

efficiency gains resulting from a prescriptive approach are static, one time events that require maintenance through regulatory oversight, with no assurance that the resulting rates reflect the underlying cost of providing the service.[64]

Time Warner also agrees with SBC that the market-based approach requires time to take effect, and that claims that the market-based approach has failed are severely premature. Time Warner urges the Commission to allow additional time, noting that there is substantial evidence that the process has already begun (the Commission's "Trends in Telephone Service" report shows that CLECs doubled the amount of fiber they had installed from the end of 1995 to the end of 1996).[65]

B. ACCESS RATES CANNOT BE LEGALLY REDUCED TO "ECONOMIC COST."

Some parties argue that the Commission should adopt a timetable by which access charges must be reduced to economic cost. C&W wants the Commission to require that the state PUC approved cost materials should be filed with the next Annual Access adjustment, scheduled for July 1999.[66] According to Comptel, cost-based access achieves a "minute is a minute" pricing for equivalent functionalities provided to carriers.[67] MCI argues that the Commission should prescribe forward-looking cost-based access charges as long as the ILECs retain monopoly power.[68] Sprint claims that rather than reexamine the price cap X-Factor, the Commission should focus on a time-limited transition to bring access charges to forward-looking costs[69]

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[64]Time Warner p. 3
[65]Time Warner p. 4
[66]See also Comptel pp. 7-8, C&W p. 8-9
[67]CompTel p. 8
[68]MCI, p. 9
[69]Sprint, p. 3

The IXCs continue to maintain that prescribing interstate access rates to economic cost is the only way to enable competition.[70] In entertaining this recommendation, the Commission should consider its implications and inevitable effect if implemented. Prescribing rates to cost clearly implies that price cap regulation is impotent; prescription would eviscerate all incentives that price cap regulation offers for enhanced productivity, cost reduction, and improved service. Nowhere in the original LEC Price Cap Order is represcribing rates to economic cost an option (since the order held that the rates were the best that ROR regulation could provide).

Only if price cap regulation would be held to be a failure, and if ROR regulation were reimposed, can rates be prescribed. Thus, slashing ILEC interstate earnings through rate prescription is a de facto return to rate-of-return regulation. AT&T, however, was allowed to prosper under price cap regulation, and enjoyed increased pricing freedoms under incentive regulation as competition matured in the long distance industry.

The inevitable outcome of rate prescription, as SBC articulated in its Comments (pp.32-33), is that network investment by both ILECs and IXCs would dry up. If IXCs can purchase access at their preferred measure of ILEC incremental cost,[71] IXCs would have no reason to invest in alternative local exchange and access facilities. No firm would incur greater expense to construct its own facilities if it could persuade regulators to mandate intermediate good prices (i.e., access) at or below the incremental cost of its existing supplier. Similarly, suppliers (i.e.,

[70] ALTS, p. 11; AT&T, pp. 1-2; C&W, pp. 8-9; MCI, p. 8.

[71] The IXCs would have the FCC use their cost models for establishing the "proper" level of forward-looking economic cost for carrier access. The hypothetical (allegedly more efficient) local exchange network imposed by these models systematically drives down the economic cost of access well below that of measures of incremental cost that more accurately reflect ILECs' actual forward-looking, efficient networks.

ILECs) lose all incentive to invest in upgrading their facilities if they are forced to sell carrier access at rates at or below the economic cost of their own forward-looking networks.

A recurring theme in a number of comments[72] is the misinformed notion that competition drives prices exactly to forward-looking long-run incremental cost (or forward-looking incremental cost plus some arbitrary allocation of shared and overhead costs). Multiproduct firms with economies of scale and scope even in competitive industries cannot survive with prices set at direct incremental cost. This process would leave shared and overhead cost unrecovered.

Forward-looking incremental unit cost represents an appropriate economic price *floor* for carrier access. Market forces do not drive prices to the floor, or to the floor plus some allocation of fixed costs. Rather, market forces reveal the true economic cost of access, driving service prices to a level that recovers the price floor (direct incremental unit cost) while adding as much contribution to shared costs as demand conditions allow. In competitive markets, demand conditions determine appropriate contribution levels; these levels must be above direct incremental unit cost (sometimes substantially above) in order for the firm to cover its total economic costs of production.

Dr. William Taylor's analysis in USTA's Comments (Attachment B, p. 14) illustrate that in competitive industries faced with significant fixed costs—including the U.S. long distance industry—service prices systematically exceed incremental cost. Dr. Taylor shows that the contribution per minute in residential interstate long distance "far exceeds the contribution in

[72] AT&T, p. 3, C&W, p. 8, MCI, p. 23.

carrier access charges." Empirical data demonstrate that even in very competitive markets, prices exceed incremental cost, sometimes by surprisingly large margins.[73]

Declaring federal legislative and regulatory pro-competitive initiatives dismal failures,[74] MCI strongly recommends the Commission prescribe a $10 billion reduction in LEC access charges to "reflect true economic cost."[75] According to MCI, attempts to intensify competition in local exchange and exchange access markets generally are frustrated by ILEC "roadblocks," including "access practices, terms and conditions that are designed to make it difficult for interexchange carriers … to migrate access to other vendors."[76]

Concluding the Commission's market based approach is a "failed experiment,"[77] MCI urges the FCC to "open a supplementary pleading cycle to collect econometric models of forward-looking access cost"[78] presumably to justify prescribing a $10 billion reduction in ILEC access charges. Asserting "studies that evaluate an ILEC's specific costs are unnecessary for the purpose of determining forward-looking access pricing," MCI presumably seeks to convince the Commission that prices based on MCI's opinion of what they ought to be are somehow superior to prices reflecting the actual costs of supplying access services. Collecting econometric models

[73]See A. Larson, "A Price is Not a Formula," Public Utilities Fortnightly, September 1, 1996. Larson concludes that, "contribution margins in fiercely competitive markets are surprisingly large." He cites markets for: (1) audio CDs with contributions approaching 60%, (2) mid-priced running shoes with contributions exceeding 100%, (3) Levi's jeans priced with a 40% gross margin, and (4) PCs selling at 23% margins.

[74]"Meaningful levels of exchange access and exchange telephone service competition have not developed, and will not develop in the foreseeable future." MCI, p. 7.

[75]Id., p. ii.

[76]Id., p. 5.

[77]Id., p. 9.

[78]Id., p. 26.

nevertheless appears superfluous since MCI has already precisely determined that ILECs' forward looking economic costs of providing access services are $10 billion lower than current revenues.[79]

MCI essentially contends that since it (and presumably other IXCs and CLECs, such as Teleport/AT&T) will not be committing sufficient capital to constructing widespread local exchange and exchange access network facilities to effectively compete with ILECs, the FCC must prescribe a $10 billion reduction in current ILEC access charges.

Interpreted another way, MCI claims ILECs are earning $10 billion in "excess" profits in exchange access markets. Profits that far above competitive levels would attract huge and immediate entry, with the ensuing price competition quickly eliminating the "excess" profits. Perhaps this is the motive for the major IXCs' recent acquisitions of competitive access providers. However, rather than devote a significant amount of capital to expanding these newly acquired local networks, the major IXCs are strongly urging regulators to lower ILEC rates to levels that might be below the current costs of providing access services.[80]

If MCI claims "excess" profits of $10 billion are insufficient to prompt substantial new investment in competitive local network facilities, it is unlikely such investment will be forthcoming following a price reduction intended to lower ILEC revenues by $10 billion. Rather than somehow increasing competition in exchange access markets, prescribing a $10 billion reduction in ILEC access charges will substantially dampen both competitors' and ILECs' investment incentives.

Any notion that a prescribed reduction in ILEC access charges would be accumulated by

[79]Id., p., i-ii.

[80]MCI prefers forward looking cost "forecasts" from econometric models to examining the actual costs of ILECs providing these services. MCI, p. 26. Rather than academic purity, MCI's

IXCs to invest in constructing local network facilities ignores the perception of the long distance market as vigorously competitive. If toll markets are intensely competitive, at least one IXC would reduce retail long distance prices, attempting to capture market share from its rivals. Other IXCs would institute similar price reductions to prevent this market share erosion. Otherwise, a prescribed reduction in ILEC access charges might only signal the beginning of an investment cash hoarding period.

The "enormous benefits to consumers" MCI foresees if the Commission prescribes a substantial reduction in ILEC access charges is presumably predicated on significant reductions in retail long distance prices.[81] Such retail price reductions, of course, eliminate the potential for hoarding retained earnings in anticipation of massive IXC investments in local network facilities. Further, it is not certain that the full, or even most, of a prescribed ILEC access charge reduction might be passed through to consumers in the form of toll price reductions. To the extent IXCs' decrease retail long distance prices, such price reductions are more likely to benefit high volume business customers (a market segment typically considered to be intensely contested) than the residential consumers that only occasionally purchase toll calls. Expecting major national economic benefits, such as reduced unemployment rates, from decreases in business long distance prices is indeed optimistic. Theoretically, such a toll price reduction would be expected to stimulate business, and hence overall economic, activity. However, whether such positive benefits would be substantial enough to measure is debatable.

C. THE AD HOC AND COMPTEL PROPOSALS ARE FATALLY FLAWED.

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position might rest on a conviction that econometric models can be appropriately "calibrated" to produce "estimates" below actual ILEC operating expenses.

[81] Id., p. 22.

Ad Hoc recommends that the Commission consider Ad Hoc's "Make Whole or Make Money" framework. The "Make Whole or Make Money" approach would allow ILECs to choose between a "make whole" option of guaranteed recovery of their embedded accounting costs, including the excess above economic cost levels, but under Commission oversight of their earnings and pricing; and a "make money" option, in which the ILEC would accept a prescription of access rates at economic (TSLRIC) levels, but with pricing flexibility and no regulatory restraints on earnings.[82]

Ad Hoc promotes its "Make Whole or Make Money" approach as a reasonable compromise offering to the Commission in this proceeding. While somewhat innovative, the basic premise in its "make money" option does not hold together. Under the "make money" approach, "the ILEC would accept a prescription of access rate at economic (TSLRIC) levels, but with pricing flexibility and no regulatory restraints on earnings."[83] The lack of earnings restraint is entirely meaningless with access prices set at cost. By definition, there are zero economic profits when price equals incremental unit cost. Interstate earnings would not exist under this assumption.

Further, there would be no possibility of exercising pricing flexibility with prices set at incremental cost. Exercising flexibility would entail lowering some prices while raising others. ILECs could not offer access price decreases without pricing below incremental cost and risking possible antitrust scrutiny. The firm would not be covering its common costs; revenues from selective price increases would not to go to cover associated shared and common costs. Excess revenues would be depleted in covering common costs before they could be used to recover the

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[82] Ad Hoc, pp. 33, 34.
[83] Ad Hoc, p. 34.

losses endured in selectively pricing below cost. No firm could break even, much less "make money" under Ad Hoc's construct. Ultimately, rate prescription to cost and rate flexibility are mutually exclusive practices.

CompTel proposes a Prescriptive Transition Plan that establishes priorities in access reform and transitions access rates to cost promptly. According to Comptel, these priorities are necessary because each category of services—terminating access, originating access and transport—is subject to differing degrees of market pressures.[84]

While CompTel calls for a more gradual prescribed reduction of access charges to incremental cost, the more gradual timeframe does not change the fruitless economic effect of implementing such a plan. The ultimate result of CompTel's plan is to set access rates equivalent to incremental cost. This eventual result would dismantle any incentive of CLECs or IXCs for investing in alternative local exchange and carrier access services. If IXCs could purchase carrier access at the ILECs' true incremental cost (or lower, as the HAI model would dictate), they could do no better investing in their own facilities. Thus, IXC facility investment would dry up.

Likewise, with ILECs forced to sell their network access capacity at cost, they would have no incentive to invest in network upgrades and improvements since the full cost of such upgrades plus a reasonable return could never be recovered through prescribed access prices. Thus, CompTel's prescriptive plan would fully encumber market mechanisms from driving prices to competitive levels. In the end, CompTel's plan is little different from other parties' unfounded calls for immediate and full prescription of access rates to incremental cost.

D. THERE IS NO SPECIAL BASIS TO PRESCRIBE RATES FOR TERMINATING ACCESS.

[84] CompTel, p.13-14.

C&W believes that competition in the provision of originating switched access services may develop well before there is competition for transport or termination.[85] Sprint claims that some CLECs are attempting to impose excessive access charges on IXCs, so as to use IXCs as a source of funding their start-up costs and/or financing commercially attractive local retail rates.[86]

These assertions, however, do not provide any basis to prescribe rates (or even to regulate them) for terminating access. The Access Charge Reform Order instituted rules that reduce terminating access much more quickly and to an even greater degree than originating access. The "cascade" mechanism for flowing through access reductions first directs them to reduce the TIC, and then to reduce terminating access rate elements until they are eliminated. This structure responds to any concern that competition will come to originating access sooner than to terminating. The Commission should reject C&W's request since the Commission has already corrected any perceived disparity in originating and terminating rates.

V. OTHER CLAIMS ARE IRRELVANT AND NEED NOT BE ADDRESSED.

A. ACTA'S CLAIMS OF HARM TO SMALL BUSINESS ARE UNFOUNDED.

ACTA argues that the Commission must conduct an adequate analysis of the effect of its access reform changes to small business under the regulatory flexibility act (RFA).[87] ACTA asserts that the Commission's pricing differential between tandem switching and direct trunk routing offends Congress's intent to foster equitable and rationally priced telecommunications competition as embodied in the 1996 Act, as well as the RFA. [88]

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[85] C&W, p. 6.
[86] Sprint, p. 5.
[87] ACTA, p. 6.
[88] ACTA, p. 9.

ACTA's claim is unfounded. The arguments raised by ACTA regarding the effect of Access Reform on small business have had an adequate opportunity to be weighed by the Commission, to the extent that ACTA properly raised them in the 1997 Comment cycle. To the extent that ACTA desires additional explanation on the rulings in the Access Charge Reform Order, ACTA should await the response to its Petition for Expedited Reconsideration.

B. CALIFORNIA NRCs ARE REASONABLE.

MCI claims that UNE-based competition has also been harmed by the relationship between UNE prices and the regulated price of local exchange service from the incumbent. MCI asserts that in many cases the combination of recurring and non-recurring charges for UNEs and collocation makes the provision of UNE-based service uneconomical, as in California, where allegedly excessive NRC's create a barrier to competition.[89]

MCI's dissatisfaction with state arbitrated and approved UNE rates, discounts the lengthy process that state PUCs have gone through in approving all UNE charges. The Eighth Circuit determined that it is the purview of state regulators to determine appropriate wholesale prices, and state regulators have taken on that charge. Apparently, since MCI did not achieve as favorable an outcome on the NRC issue as it would have liked, it wishes to have the Commission conclude that the entire state regulatory cost examination process is without any merit. The Commission must not be so tempted.

C. PASS THROUGH OF UNIVERSAL SERVICE CONTRIBUTION IS APPROPRIATE

OCI complains of the practice of LECs of passing through to their access charge customers the costs of those LECs' own universal service contributions as exogenous charges.

[89]MCI, p. 16--also see fn. 26;see also AT&T, p.7.

OCI claims that treatment is inconsistent with the requirement articulated elsewhere in the very same order that universal service contributions should be based on "end user telecommunications revenues." OCI argues that inclusion of universal service costs in the prices for the services being resold combined with the obligation on those access customers to remit their own universal service contributions based on revenues derived from their provision of telecommunications services to end users results in a double payment of universal service contributions by the access customers and that this process is not competitively neutral.[90]

In adopting “retail telecommunications revenues” the Commission sought to avoid a double accounting of universal service monies.[91] Paragraph 846 of the Universal Service Order recognizes that “carriers will pass on some portion of the cost of contribution to their customers.” This matter is again recognized in paragraph 850 of the same order.

Assuming that all carriers possess an obligation to contribute to universal service funding, their retail revenues would likely also reflect the universal service-related costs referenced by OCI, and the process will be competitively neutral. Therefore, any universal service-related costs which OCI incurs for services it purchases to resell, will ultimately be reflected in the prices its charges its customers and therefore in the calculation for its universal service contribution.

Unfortunately, OCI fails to correctly portray the impact of this process. The assessment of retail telecommunications revenues is only necessary to determine the respective universal service contribution percentages for each telecommunications carrier. These revenue analyses do not determine what level of funding of universal service is necessary. That process is still under consideration by the Joint Board (i.e., methodology approach) and by the Commission (i.e. cost

[90]OCI, p.3.

[91]Report and Order, In the Matter of Federal-State Joint Board on Universal Service, CC

proxy model development). The percentages will be multiplied by the universal service requirements still under consideration to determine a contribution amount for each telecommunications carrier. That carrier will contribute an amount which reflects only its universal service obligation as determined by its specific representative share of retail telecommunications revenues and by the total universal service requirement. Thus, no more that the total requirement will be collected from all telecommunications carriers and no more than the representative share will be collected from any telecommunications carrier. (Universal Service Order at paragraph 854.) Access customers will not be double paying as claimed by OCI. Each dollar of requirement will only be charged and collected one time.[92]

In summary, the Commission recognizes that universal service-related costs will ultimately be reflected in both wholesale and retail rates. In order to avoid a double counting of the monies, the Commission adopted retail telecommunications revenues. In this manner, even though universal service-related costs may be inherent in the charges paid to facility-based carriers by resellers, those costs will ultimately be reflected in the charges billed by the reseller to its customer. Such a process does not increase in the size of the fund. Admittedly, it may increase the contribution burden on the reseller, but such is legitimate to the extent that the costs are indeed properly assigned to the services purchased by the reseller. This legitimacy is perpetuated as the reseller passes its cost of providing service, including universal service-related costs, to its customers.

Docket No. 96-45, FCC 97-157, May 8, 1997, paragraphs 843 - 844.

[92]In fact, what OCI appears to be requesting is that the ILECs not be permitted to recover the whole of the costs underlying the provision of services to resellers such as OCI, similar to crediting the reseller's universal service contribution obligations for the provision of supported services. The Commission denied such an approach in paragraph 857 of the Universal Service Order.

VI. CONCLUSION.

For the foregoing reasons, SBC respectfully requests that the Commission promptly adopt the pricing flexibility proposal proposed by USTA, reduce the x-factor to reflect the most recent data, and deny the CFA and MCI Petitions.

Respectfully submitted,

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Appendix A

Ad Hoc Telecommunications Users Committee (Ad Hoc or the Committee)
America's Carriers Telecommunications Association (ACTA)
American Petroleum Institute (API)
Ameritech
Association For Local Telecommunications Services (ALTS)
AT&T Corporation (AT&T)
Bell Atlantic Telephone Company (Bell Atlantic)
BellSouth Corporation (BellSouth)
Cable & Wireless USA, Inc. (C&W)
Cincinnati Bell Telephone Company (CBT)
Communications Workers of America (CWA)
Competition Policy Institute (CPI)
Competitive Telecommunications Association (Comp Tel)
Consumer Federation of America (CFA)
Consumers Union
Corecomm Newco, Inc. (CoreComm)
CTSI, Inc. (CTSI)
Enterprise Networking Technologies Users Association (ENTUA)
Excel Telecommunications, Inc. (Excel)
General Services Administration (GSA)
GTE Service Corporation (GTE)
International Communications Association (ICA)
KMC Telecom, Inc. (KMC)
MCI Worldcom, Inc. (MCI)
MediaOne Group, Inc. (MediaOne)
National Retail Federation (NRF)
Operator Communications, Inc. (OCI)
RCN Telecom Services, Inc. (RCN)
Sprint Corporation (Sprint)
Telecommunications Resellers Association (TRA)
The Office of Advocacy of the United States Small Business Administration (Advocacy)
Time Warner Telecom Corporation (Time Warner)
U S West Communications, Inc. (U S West)
United States Telephone Association (USTA)
Washington Utilities and Transportation Commission (WUTC)
Western Wireless Corporation (Western Wireless)